Fundamentals of Accounting –I

CHAPTER ONE

INTRODUCTION TO ACCOUNTING AND BUSINESS

Learning Objectives

- Describe the nature of Businesses and the role of Accounting in Business
- Summarize the development of accounting principles and relate them to practice
- State the accounting equation and describe each element of Accounting equation
- Describe and illustrate how business transactions can be recorded in terms of the resulting change in the elements of accounting equation
- Describe financial statements and their relation ships

The nature and types of business

- A business organization is an economic entity which is engaged in converting basic inputs(raw material) into products or provision of service for sale at *profit* to customers.
- The objective of most businesses is to earn a profit. Profit is the difference between the amounts received from customers for goods or services and the amounts paid for the inputs used to provide the goods or services.

TYPES OF BUSINESSES

- Based on the *activities* in which they are engaged businesses can be classified in to four:
  - Service giving businesses
  - Merchandising businesses
  - Manufacturing businesses
  - Construction firms
- Based on their legal form , there are three different legal forms of businesses:
  - *Sole proprietorship*
  - *Partnership*
  - *Corporation*

The role of accounting in business

Accounting

Information system

Supply of information

Service activity

Demand for information

Analytical descriptive discipline

Financial performance

Financial position

Liquidity, etc

Input

Economic Activities

Process

Accounting Cycle

Output

Financial Information

Accounting Definition

- Accounting can be defined as: an information system that **provides information to users** about the economic activities of the company so that the users can make informed decisions.
- it is also commonly known as the "**language of business".** It is used as a means to exchange information among interested parties concerning the financial performance, financial position and related issues of an organization,
- Accounting is the activity of **identifying, analyzing, measuring , recording, summarizing, communicating and interpreting** financial information to the *users*.

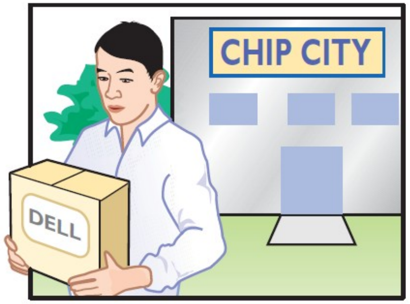
Accounting Definition

- ***Identifying*** - tracing and collecting recordable economic activities. Accounting does not record and report all economic activities of an organization. Rather, it records and reports only those economic activities of the organization which can be expressed in terms of money.
- **Analyzing and Measuring** - This involves determining whether the economic activities bring changes (increase/decrease) assets, liabilities, capital, revenues, and/or expenses .
- **Recording** - make, in a systematic way, a record of the effects of economic activities on assets, liabilities, capital, revenues and expenses.
- ***Classifying & Summarizing*** - grouping recorded effects of economic activities into meaningful classes and arranging data needed for preparation of reports

- **Reporting** - preparing statements and reports in a manner that suits the need of users so as to communicate information useful for decision making.
- **Interpreting** - provide explanation on reported information so that users can understand and use the information as a basis for decision making

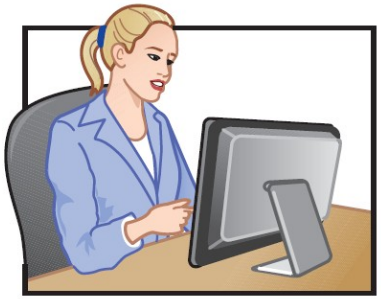
The activities of the accounting process

Identification



Select economic events (transactions)

Recording



Record, classify, and summarize

Communication

Prepare accounting reports

Analyze and interpret for users

The accounting process includes the **bookkeeping** function.

Who Uses Accounting Data- Users of Accounting Information

1. Internal Users

- **Finance Department** - Is cash sufficient to pay dividends to the company's stockholders?
- **Marketing Department** – What price should the company charge for a product to maximize profit?
- **Human Resources Department** – Can the firm afford to give its employees pay raises?
- **Managers** - Which product line is most profitable? Should any products be eliminated?

Who Uses Accounting Data- Users of Accounting Information

External Users

- **Investors:** Is company’s earning satisfactory ? How is its profitability with others
- **Creditors** – Will the firm be able to pay its debts as they come due?
- **Existing and potential suppliers** : they want to assess the ability of the business to pay for goods and services supplied .
- **Government agencies/ tax authority:** who need to assess how much tax the business should pay

Profession of Accountancy

- **Profession of Accountancy** - Accounting is an occupation, which requires advanced education and special training.
- After completing the required education and training accounting professionals may work as *private* or *public* accountants.
  - ***Private* accountants** refer to those accountants who work for a single employer on salary basis. Private accountants may assume different positions with in an organization including chief accountant, financial manager, controller, budget officer and cost accountant.
  - ***Public* accountants** refer to those accountants who provide professional services to the public in general on a fee basis. They include certified

Specialized Fields of Accounting

- Specialized Fields of Accounting - accountants may specialize in one of the following fields:
  - ***Financial* accounting** - area of accounting aimed at serving information needs of **external users**.
  - ***Managerial* accounting** - field of accounting concerned with serving information needs of **internal users - managers**.
  - ***Cost* accounting** - a managerial accounting activity designed to help managers in identifying, measuring and controlling operating costs.
  - ***Tax* accounting** - field of accounting that includes preparing tax returns and planning future transactions to minimize (*not of course to evade which is an illegal act*) amount of profit tax payable.

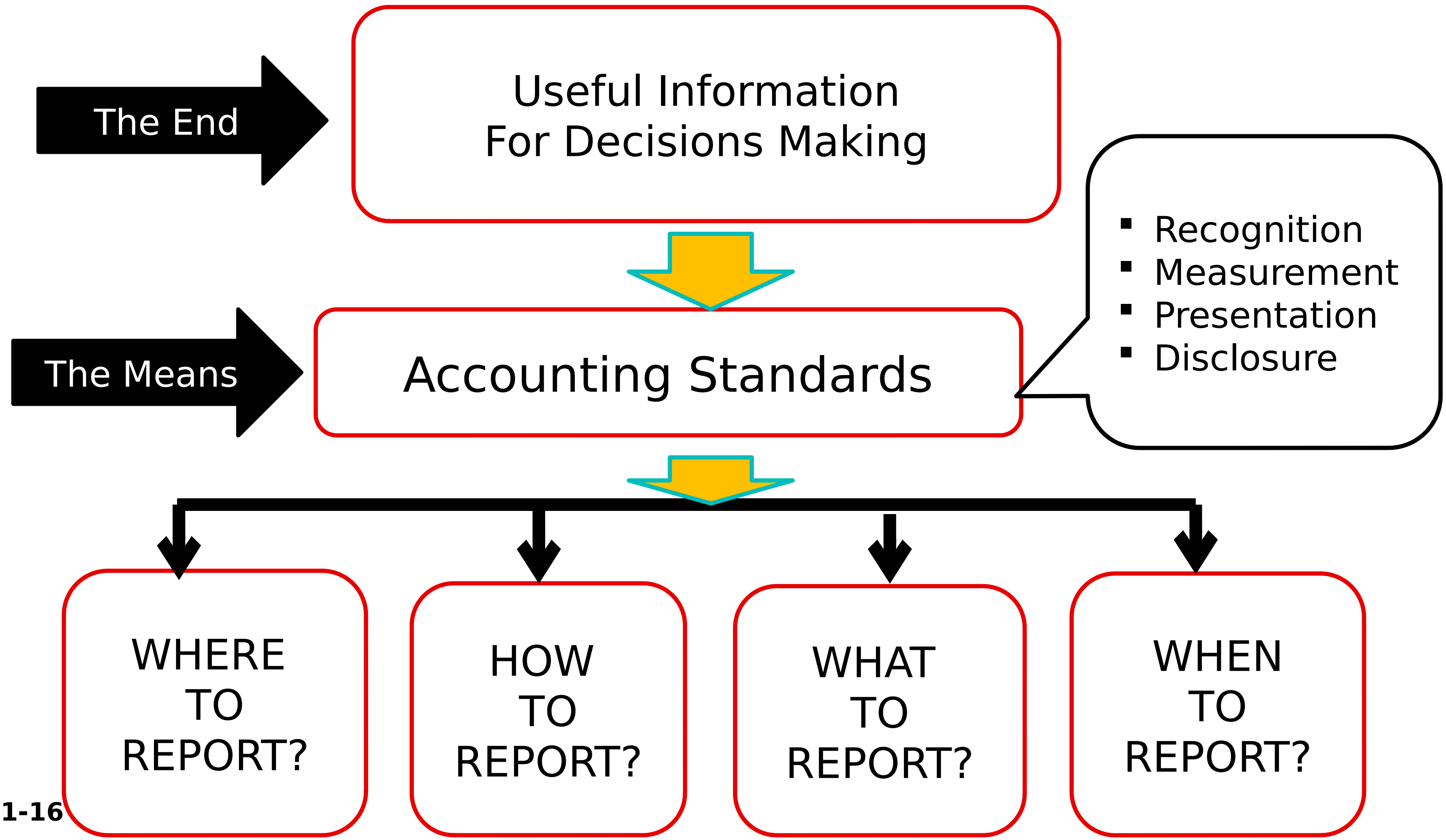
Evolution of Accounting

- Accounting has evolved as a the result of changes in socio economic, political and technological environment.
- Historically there was an evidence of record keeping in Babylonia around 3600 BC to provide information for **wage payments.**
- The ground breaking achievement in the history of Accounting was, however, the innovation of Double entry system in the late 15th century by Luca Pacioli, an Italian Renaissance mathematician.
- In addition, the industrial revolution of mid-nineteenth Century , expansion of business operation and formation of large corporation in 20th Century and advancements in technology has necessitated accounting.

Generally Accepted Accounting Principles/Accounting Standards

- **The accounting profession has developed standards that are generally accepted and universally practiced**.
- These standards indicate how to report economic events.

ACCOUNTING STANDARDS



Accounting Standard-Setting Bodies:

International Accounting Standards Board (IASB)

http://www.iasb.org/

- Issues International Financial Reporting Standards(IFRS)
- Applied mostly by countries other than USA , including ethiopia

Financial Accounting Standards Board (FASB) http://www.fasb.org/

- **.Issues Generally Accepted Accounting Principles (GAAP)**
- **Applied by USA**

Ethiopia and Accounting standards

- In Ethiopia, Accounting and Auditing Board of Ethiopia (AABE) is responsible to Issue standards and directives relating to financial reporting and auditing.
- Ethiopia passed a financial reporting law in 2014, Proclamation No. 847/2014 and Regulation No. 332/2014, which requires the use of IFRS by commercial businesses operating in Ethiopia.
- Therefore, Ethiopia has adopted IFRS/IPSAS since 2014 for its business companies and NGOs

What is IFRS?

- IFRS (International Financial Reporting Standards) **is single-set of high quality, globally accepted and enforced set of standards** that require high quality, transparent and comparable information in financial statements
- is issued by IASB [International Accounting Standards Board]
- **Those Standards prescribe:**
  - the items that should be recognized as assets, liabilities, equity revenue and expense
  - how to measure those items;
  - how to present them in a financial statements; and
  - Related disclosures about those items

IFRS standards

International Accounting Standards (IAS) - 24

International Financial Reporting Standards (IFRS)-17

Standing Interpretations Committee (SIC)- 5

International Financial Reporting Interpretations Committee (IFRIC)- 13

Qualitative Characteristics of Accounting Information

- Fundamental Characteristics
  1. Relevance
  2. Faithful representation
- Enhancing Characteristics
  1. Comparability
  2. Verifiability
  3. Timeliness
  4. Understandability

Accounting Principles and Assumptions

Measurement Principles

HISTORICAL COST PRINCIPLE (or cost principle) dictates that companies record assets at their cost.

FAIR VALUE PRINCIPLE states that assets and liabilities should be reported at fair value .

Assumptions

- **MONETARY UNIT ASSUMPTION :** requires that companies include in the accounting records only transaction data that can be expressed in terms of money.

- **ECONOMIC ENTITY ASSUMPTION:** requires that activities of the entity be kept separate and distinct from the activities of its owner and all other economic entities.

- **Going Concern Assumptions :** This concept assumes that the organization has indefinite life or the existence of business for indefinite period of time to the future

- **Periodicity Assumption:** Even though the entity is assumed to be going concern, periodic classification continue; i.e., Monthly, quarterly, yearly for reporting purpose so that the

The Basic Accounting Equation

Basic Accounting Equation

- Provides the **underlying framework** for recording and summarizing economic events.
- Assets **must** equal the sum of liabilities and equity.

Assets = **Liabilities** + **Equity**

Basic Accounting Equation

Assets = **Liabilities** + **Equity**

Assets

- Resources a business owns.
- Provide future services or benefits.
- Cash, Inventory, Equipment, etc.

Basic Accounting Equation

Assets = **Liabilities** + **Equity**

Liabilities

- Creditors Claim against assets (debts and obligations).
- Creditors (party to whom money is owed).
- Accounts Payable, Notes Payable, Salaries and Wages Payable, etc.

Basic Accounting Equation

Assets = **Liabilities** + **Equity**

Equity

- Owners claim on total assets.
- Referred to as residual equity.
- Increases by owners **investment and revenue**
- Decreases by owners **withdrawal and expenses**

Equity

Investment by Owner : are cash/ other assets the owner puts into the business

Revenues : are increases in assets or decreases in liabilities resulting from sale of goods or performance of services in normal course of business

Common sources of revenue are: sales, fees, commissions, interest, dividends, and rent.

Expenses are the cost of assets consumed or services used in the process of earning revenue.

Common expenses are: salaries expense, rent expense, utilities expense, depreciation expense, etc

Withdrawals are cash or other assets taken by owner

Business Transaction

Business Transactions:

- are a business's economic events recorded by accountants.
- are economic events that affect one or more elements of the accounting equation
- Each transaction has a dual effect on the accounting equation.
- May be external or internal.
- **Example:**
  - Purchase of equipment for cash

Transaction Analysis- Recordable event

Not all activities/event represent transactions.

Illustration: Are the following events recorded in the accounting records?

Event	Purchase computer	Discuss product design with potential customer	Pay rent
Criterion	Is the financial position (assets, liabilities, or equity) of the company changed?		
	Yes	No	Yes
Record/ Don't Record			

Summary of Transactions Analysis

1. Each transaction must be analyzed in terms of its effect on:

   a. The three components of the basic accounting equation.

   b. Specific types (kinds) of items within each component.

2. The two sides of the equation must always be equal.

3. Capital: columns indicate what causes the change in owners equity(investment, revenue , expense and drawing)

Financial Statements

Companies prepare four financial statements:

Income Stateme nt

Statement of owners equity

Stateme nt of Financial Position

Stateme nt of Cash Flows

Financial Statements

- Each Financial Report has heading and body
- Heading contains:
  - The name of the company
  - The type of report
  - The period of the report

Income Statement

- Reports the profitability of the company’s operations over a specific period of time.
- Lists revenues first, followed by expenses.
- Shows net income (or net loss).
- Does not include investment and dividend transactions between the owner and the business.

Owners Equity Statement

- Reports the changes in capital during a specific period of time.
- The time period is the same as that covered by the income statement.
- Information provided indicates the reasons why the capital has increased or decreased during the period.

Statement of Financial Position

- Reports the assets, liabilities, and equity at a specific date.
- Lists assets at the top, followed by liabilities and equity.
- Total assets must equal total liabilities and equity.
- Is a snapshot of the company's financial condition at a specific moment in time (usually the month-

Statement of Cash Flows

- Information on the cash receipts and payments for a specific period of time.
- Answers the following:
  - Where did cash come from?
  - What was cash used for?
  - What was the change in the cash balance?

HELPFUL HINT
Investing activities pertain to investments made by the company, not investments made by the owners.

Transaction Analysis- The following transactions were made during the month of September 2020

1. *Abebe opened a mobile maintenance shop by renting 3x4 office room on Marathon building. He named his business ABE mobile and deposited cash of Birr 15,000 in the account opened in the name of ABE Mobile. He has $250,000 cash in his personal bank account with Dashen Bank and $50,000 cash in a safe deposit box at his residence*
2. *ABE Mobile purchased computer for Br 7,000 cash.*
3. *Paid monthly rental of br 5,000 in advance.*
4. Abebe transferred furniture worth birr 30,000 from his home for office purposes by ABE mobile
5. *Purchased Supplies(sanitary materials) of birr 1,500 on credit . 2/3 is for ABE mobile use and 1/3 is for personal home use*
6. *Receives br 1,200 cash from customers for maintenance services it has provided.*
7. *Paid a radio advertisement cost of birr 500*
8. *Provides br 3,500 of maintenance service to customers. Of which, 1,500 is on cash and br 2,000 on account.*

Transaction Analysis-

9. Paid the following expenses in cash for September: store rent 600, salaries of employees 900, and utilities 200.
10. Rendered maintence services worth 15,000 to clients promising to pay in the near future.
11. collected 5,000 cash from clients who received services in item-10 above
12. sold one of the furniture invested by its owner for 5,000 cash. The furniture had a recorded value of 5,000
13. borrowed 4,000 cash from Dashen Bank. The loan is repayable over ten months.
14. determined that cost of supplies remained on hand at the end of the current month total br 300.
15. At the end of the month , the monthly rental paid has expired.
16. paid birr 500 cash to Dashen Bank consisting of 400 principal and 100 one month interest on the loan due during the month.
17. AH paid its owner 3,000 cash for personal uses (to pay house utility expenses).

- **Required:**

1. Record the transaction for ABE mobile using accounting equation with the following items:

   Assets: Cash, Account Receivable , Supplies, Computer, Furniture

   Liability: Account Payable, loan Payable

   Equity: Investment by owner, Fees Revenue, Expense, withdrawal

2. Prepare Financial statement for the month of September